AN APPRAISAL OF LITERATURE CRITICAL OF COST BASIS ACCOUNTING

BY

MING-PO HSU

B.S., National Chiao-Tung University, Shanghai, China, 1941
M.S., University of Illinois, 1948

AN ABSTRACT OF A THESIS

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
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IN THE GRADUATE COLLEGE OF THE
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Criticism is invariably an expression of dissatisfaction. It frequently constitutes the cradle of improvement. The development of a special field of knowledge always has to pass through continuous experiments and criticisms which serve like a refinery from which systematic and logical thinking emerges. These results will be generally accepted until new dissatisfaction provokes succeeding experiments and criticisms which eventually crystalize a better result. Criticism is therefore a source of progress; it is worthy of repeated examination.

The generally accepted cost basis accounting has long been under criticism that it fails to reflect changes in the value of assets (and costs) in the accounting records and in the financial statements. The strict cost basis accounting has been criticised from both the balance sheet standpoint and the income statement standpoint. In the first place, the presentation of asset items in the balance sheet on a cost basis always tends to be a source of dissatisfaction, no matter how logical the new interpretation is. The balance sheet as a statement of financial condition has been so deep a traditional concept that businessmen and accountants, in periods of major price movement, cannot help but think that the cost basis is all to blame for the statement's failing to reflect current value. Next, the ignorance of the economic fact that the significance or value of the dollar is constantly changing has hopelessly become one of fundamental weakness of present cost basis accounting. Both asset accounts balances and income figures may be, as has been said, just residual mixtures of non-homogeneous units.

Orthodox accountants have so far declined to record current values except in certain current assets, notably the inventory account, which have long been valued on the basis of cost or market whichever is lower; even in the latter

cases it is due to the profession's inclination to be conservative rather than to the profession's consciousness of the significance of the current value. They set up the going concern value theory to deemphasize the current values of the fixed assets, disregarding whether the current value becomes higher or lower than the original cost. However, historical cost actually does not approximate the constantly changing current value on the one hand nor does it continue to represent the original economic significance of the recorded dollar units on the other. It is no wonder that every time major price movements occur there are voices from the businessmen and accounting writers criticizing the conventional cost basis concept and demanding a new or modified practice.

Practically, orthodox accountants on occasion have had to give concession to some departure from cost basis procedure. The upward revaluation of capital assets became a popular practice in 1920's under the pressure of optimistic businessmen. Also, the wave of downward revaluation of capital assets in the 30's met little opposition from accountants. The later examples are the general application of the last-in, first-out procedure of inventory valuation and the use of the so-called 'accelerated depreciation' in the recent years. All of them represent some compromise device between upholding the conventional cost basis principle and meeting the prevailing demand for recognizing the significance of current values.

Nevertheless, the problem is still there. It is referred to as a value vs. cost controversy. It has been generally recognized as a dilemma of accounting. The accounting authorities generally make no attempt to conceal or deny the limitations in the present cost basis accounting, but they have made no active effort to seek a solution to that fundamental problem either. Their attitude seems rather conservative; they tend to hold the belief that there is no available way ideal enough to remedy that defect, that the present change in the value of dollar is not so serious as to be worth an adjustment of the whole recorded costs, etc. Obviously, this is no way out. The right way seems to be that accountants ought to take an active,

constructive attitude to face the 'dilemma' instead of either declaring adherence to the cost basis or trying to belittle its unsatisfactoriness in serving accounting's purpose.

One way to approach the goal is to look back and to recognize the contributions in the accounting literature which has criticized the conventional cost basis accounting and has suggested remedial programs. A re-examination of this literature may be expected to supply a direct and good basis for further study. The criticisms may not be fully correct because of misunderstanding or prejudiced thinking, yet they unmistakably present the demands of certain group interested in the accounting information. But more important is a review of the remedial programs usually presented in company with the criticisms. Although those remedial suggestions have seemingly met less favorable reaction than the criticisms, a comparative study of their reasoning and practicability and an examination of the idea underlying the subsequent unfavorable reaction may be the best starting point and probably reveals the right direction to seek a new program which will serve the accounting purpose better than the present practice.

In this thesis, four books critical of the conventional accounting are re-examined with the above mentioned significance in mind. They are:

(1) H. W. Sweeney: *Stabilized Accounting,*

(2) Kenneth MacNeal: *Truth in Accounting,*

(3) Arundel Cotter: *Fool's Profits, and*

(4) William B. Castenholz: *A Solution to the Appreciation Problem.*

They all charge that the conventional historical cost basis accounting is incorrect and misleading because it does not reflect the effect of changing price levels in the accounts; but their viewpoints are not the same and their remedial programs vary widely from each other in their emphasis on asset valuation and income determination. It is presumed that those four writings well represent the past efforts in trying to

expose and remedy the defects in conventional accounting because of price level changes.

The Selected Literature

(1) H. W. Sweeney: *Stabilized Accounting.* New York & London, Harper & Brothers Publishers, 1936, 219p.

Sweeney's critique on the conventional accounting points to the basic deficiency, namely the assumption that the value of dollar is constant and to the unsoundness of the principle that the object of accounting records is dollar figuers rather than the dollars' value; this critique naturally relates to the whole body of accounting. His remedial program includes mainly the idea to convert all accounting figures in ordinary accounts into figures in terms of a unit having certain and definite value, or to periodically adjust the book balances into their current equivalent according to the changes in the general purchasing power of money; so that all accounting balances are stated on a homogeneous basis — Sweeney terms it 'stabilized' basis. The function of stabilization is to make possible intelligent analysis of the accounting figures and comparisons between them (i.e., between asset and asset, assets and liabilities, assets and capital, liabilities and capital, and also between revenues and cost — i.e., the income determination) throughout the periods of fluctuating price levels.

Sweeney's stabilized accounting is a refinement of German inflation accounting after World War I. Under the super-inflation in the post-war Germany the incorrectness of the conventional accounting practice became microscopically exposed. But *Stabilized Accounting* is not written as an accounting system to be adopted merely during an inflation period; rather it is intended by the author as a challenge to the conventional accounting. After witnessing the evil of a great depression, Sweeney was inclined to thing that the incorrectness of accounting needs to be corrected anyway, even in times other than war inflation, because of its share, though innocent, in producing the business crisis. In his idea,

stabilization should be made an additional routine process of accounting, after bookkeepink and auditing.

Stabilized Accounting has been more or less warmly received. One reviewer's words may be cited as the summarized general impression: "Although many will disagree with Sweeney as to the practicability of his proposals, few can honestly disagree with the significance of price changes in development of accounting concepts of capital, income, and proprietorship." Almost all the reviews concede that the book is a contribution to theoretical study. It is a fact that Sweeney have made a name on the theoretical presentation of stabilized accounting, although the stabilizing program suggested by him has never gained approval or support from the accounting writers or the professionals, probably because it departs too far from the conventional concept and involves too drastic a change from the conventional practice.

The backbone of Sweeney's stabilized accounting is the concept of real capital. Under that concept, accounting is to account for the flows of purchasing power, instead of dollar units, turned in and out the business. That concept is named 'real capital' by the author in contrast to the dollar basis of the conventional concept which Sweeney calls 'nominal capital'.

It would seem in principle inconsistent if accountants recognize a concept of real capital during period of inflation but adopt a concept of nominal capital in normal time. The points most worth study are: Does the concept of nominal capital retain economic significance during an inflation period? Is or is not nominal capital just an expedient symbol of real capital? What is the deficiency of the concept of real capital? If both are expedient practices, where should the line of substitution fall?

The biggest weakness of stabilized accounting, no doubt, is in its impracticability. It is easy to say and to feel that a change in the purchasing power of money has taken place, but it is difficult, if not impossible, to measure the exact size of that change. In *Stabilized Accounting* Sweeney chooses Carl

Snyder's General Index as the measuring standard. The reliability and propriety of using that index for stabilization of accounts, however, is rather questionable. Stabilized accounting seems still like a dream of an accounting theorist because a reliable index capable of accurately measuring the purchasing power and its changes, which has yet to be sought, is the first requisite for the practising of useful stabilized accounting.

(2) Kenneth MacNeal: *Truth in Accounting.* Philadelphia, University of Pennsylvania Press, 1939, 334p.

MacNeal launches his challenge to the conventional accounting primarily from the viewpoint of the outside investing public. His is a challenge to the conventional basis of valuation, that of original cost. He calls the conventional cost basis statements as untruthful, deceiving; and he criticizes such practices as valuing fixed assets at original cost, pricing merchandise inventory at cost or market whichever is lower, and recognizing no unrealized profits as inconsistent, childish, and hiding important information.

MacNeal believes that the present economic value should substitute for the original cost as the valuation basis in accounting for both balance sheet and profit and lose statement purposes. His program of truthful accounting includes a balance sheet, in which every item of assets is to be presented at current value — with as few concessions to expediency as possible, and a profit and loss statement which shows the difference between the current value and the original cost of the assets as really earned profit (or loss). He says that such a balance sheet is not only telling what are the present values of the possessions of a business, but also is presenting a net worth whose fluctuations between the beginning and the end of any period would describe accurately the net total of all profits and losses during that period; and that such a profit and loss statement is to furnish a complete statement of all other losses and profits in addition to the information now given by conventionally prepared profit and loss statement, so

that the reader might be informed regarding every profit or loss sustained by a business during the period in question.

In comparison with stabilized accounting, MacNeal's criticism and remedial program is not very penetrating and fundamental in theoretical contribution. But on the other hand, his critique is more close to the layman's viewpoint as compared to *Stabilized Accounting* which is prepared from the viewpoint of an accounting theorist as a pure study on the logic and efficiency of the present accounting. Besides, MacNeal writes the book with too much self-confidence as if he is speaking as an authority in both economics and accounting. As a result, *Truth in Accounting* gets less compliments in the first wave of reaction — book reviews — than *Stabilized Accounting*. The reviewers may agree with the author at the idea that data of current value could be quite informative for the statement readers; but they generally feel that his view is superficial and that he has over-simplified the practical situation of ascertaining current values.

The only valid reason of MacNeal's idea to emphasize current value disclosure is that orthodix accounting provides inadequate information for the reader public and thus does cause a discrimination against outside investors. Theoretically, to reveal the present value of assets in the balance sheet is in conformity with the doctrine of full disclosure. Practically, however, the appraisal of present value, especially those of fixed assets, non-reproducible goods, intangible, etc., is no easy job even for experienced appraisers. The reliability of the results is still very doubtful.

MacNeal's idea of recognizing the changes in current value as income is not compatible with the orthodox scheme of income determination. That concept implies that MacNeal basically takes the balance sheet approach as the primary viewpoint of accounting; that is not suited to modern accounting and modern business conditions.

(3) Arundel Cotter: *Fool's Profits.* New York, Barron's Publishing Company, Inc., 1940, 174p.

Cotter's *Fool's Profits* is much narrow than the above two books in what he claims of the conventional practice that is unsound: his critique is limited to inventory valuation. He attacks only the first-in, first-out procedure, the conventional way of pricing the issue of stocks of goods. He charges that FIFO has exaggerated periodical profit and loss by including in it a part of profit or loss which actually just represents market increase or decrease of the inventories on hand. That part of profit he calls 'fool's profit' because as he says it would certainly vanish in the following period as the market turns.

Strictly speaking, Cotter's critique does not enter the field of cost vs. value controversy. Throughout the discussion, he never demanded to use appraised current value in the place of original cost either for asset valuation or for cost calculation. Presumably, Cotter is well satisfied with the historical cost basis. He appears willing to follow an extreme conservatism when he suggests to set inventory valuation at a level lower than any decline of market may reach.

Nevertheless, Cotter's LIFO is essentially a procedure of indirectly computing inventory valuation at a prior figure, and it definitely implies the adoption of the normal stock principle as the basis of income determination. The normal stock prrinciple basically views the profits as arising at the ends of buying-processing-selling-replacing cycle instead of at point of sale.

It is difficult to trace the direct reaction to Cotter's book, because LIFO method of inventory pricing has become the subject of hot discussion as an existing practice itself rather than as the author's proposed program. Practically, LIFO has gained wide support after its legalization in the Revenue Act of 1939. The limit of its application for tax purpose was further extended to retailers by the Treasury Department in 1947. On the other hand, however, accounting literature reveals that it has never been theoretically cleared by orthodox

accountants; rather it has been recognized as an expediency for matching current cost and current revenue.

(4) William B. Castenholz: *A Solution to the Appreciation Problem.* Chicago, LaSalle Extension University, 1931, 95p.

Castenholz's criticism of conventional practice is based on the recognition that the dollar has a changing economic value. But he limits his study to the problem of appreciation and depreciation provision of fixed assets. The conventional practice of disregarding present value of the fixed assets is charged to have resulted in confusion and incomparability in the operation accounts.

In his book, Castenholz recommends no appreciation for fixed assets at large, and his solution is no other than calculating depreciation expense on the replacement cost. It may be said that his proposal disregards the appreciation of fixed assets as a whole but records the realized appreciation through a continuous recognition of changes in the monetary value of plant services. The net result of his program is in fact merely to credit a portion of conventional operating profits directly to earned surplus account, nothing else. It seems more appropriate that the program be designated as a solution to the depreciation problem (in periods of changing prices) than its present designation.

The book is selected for the persent study because Castenholz's solution is probably the most definite and complete plan of a proposal of computing depreciation on the basis of replacement cost. Since the named proposal has received strong supports from the businessmen and a number of accountants during the past years, it deserves a close study of its theoretical standing.

CONCLUSIONS

In summary, the selected literature under study presents a number of unsatisfactory points of the conventional cost

basis accounting. They include: that it adopts an untrue assumption that the value of the dollar remains constant; that it accounts for the maintenance of nominal capital and nominal income rather than real capital and real income; that it fails to show the present worth of assets in the balance sheet; that it fails to disclose the increase and decrease in the present worth of assets now in the possession of the business; that it employs a practice of inventory valuation which tends to exaggerate the periodic income; and that it fails to provide for adequate depreciation. Most of those criticisms deserve serious attention.

The appraisal in the present thesis reveals that none of the suggested remedial programs can be held infallible in the examination of the basic reasoning or the practical application. It seems that the problem involves issues that are too complicated and affect too many interests for any single author to see and resolve them because of his own preoccupied viewpoint. This writer believes that accountants will have to start a serious and extensive study on all issues involved and related ideas in order to develop a satisfactory program of improvement.

The appraisal also reveals that in proposals submitted by the four authors, actually four versions of 'reflecting current condition' in the accounts are found. It thus seems that the first step toward solving the whole problem is to clarify what is the current information which accounting may be expected to provide. In this writer's opinion the current information should include two groups: one are current values of assets and liabilities which make up the financial position of the business, and the other are the current equivalents of the originally invested costs (i.e., current costs) which are to be used in the process of income determination.

This line of thinking suggests an assumption: perhaps accountants should never need to have a real controversy over 'cost' vs. 'value.' What accountants have to do is to debate between 'historical cost' and 'current cost' for income deter-

mination, and between 'non-recognition' and 'full recognition' of current values in the balance sheet. Conventional accounting is defending 'historical cost' and 'non-recognition' practices. The idea of substituting value for cost in accounting is a misunderstanding of the real issue and has somewhat clouded it.

The acceptance of the above suggestion, however, has to defy a conventional practice, the consistent treatment of valuation basis between the balance sheet and the income statement. The maintenance of that consistency of valuation basis between them may be the root of the accounting dilemma in the old 'cost' vs. 'value' controversy, because accountants are forced to pick one of the two as the primary basis of valuation in accounting. While in fact value is the better basis for balance sheet, as a statement of financial position, and cost is the only logical basis for income statement, to ignore either one in accounting reports naturally would cause dissatisfaction. The question to answer is this: Is the desirability of the additional information enough to warrant sacrifice of some degree of objectivity in the preparation of financial statements?

Another task for accountants is to improve the practicability of the ways and means of ascertaining current cost and current value. As analyzed above, index number and appraisal as they stand to-day, would not produce dependable results. Much will have to be done before they may be used regularly in accounting with satisfaction.

VITA

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